Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board	)))))	CC Docket No. 80-286

COMMENTS OF
VERMONT PUBLIC SERVICE BOARD,
VERMONT DEPARTMENT OF PUBLIC SERVICE, AND
NEBRASKA PUBLIC SERVICE COMMISSION

To: The Commission

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SUMMARY

The FCC should establish an "exit ramp" option for incumbent carriers to terminate their separations obligations. For carriers remaining subject to separations, the rules should align revenue with costs, and both should be aligned with regulatory authority over rates. In addition, separations reform should reduce the overhead of collecting separations data, and it should exclude costs associated with non-regulated services.

The freeze should not be extended again. The factor freeze has been made obsolete by FCC rulings regarding ISP-bound traffic, VoIP traffic, DSL, and fiber systems. The category freeze, as implemented, has produced a cost-revenue mismatch for special access that in some areas may be subsidizing broadband investments by raising SLCs, switched access rates and, not least, local exchange rates.

The existing Separations Manual (47 C.F.R. Part 36) is obsolete, and it needs to be modernized to account for special access, wireline broadband, DSL and fiber service. Any new manual should include a new method to categorize plant and expenses that is simpler than the existing rules but that adapts well to local circumstances. A new system should impose fewer costs on carriers, yet it must still achieve the legal goals set out in 1930 by the Supreme Court in *Smith v. Illinois Telephone* and by more modern statutory creations such as 47 U.S.C. § 254(k).

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I. INTRODUCTION

The Vermont Public Service Board, the Vermont Department of Public Service ("Vermont") and the Nebraska Public Service Commission hereby submit comments in response to the Federal Communications Commission's ("FCC" or "Commission") *Further Notice of Proposed Rulemaking* ("*FNPRM*"), released May 16, 2006 as FCC 06-70.

II. GOALS

The FNPRM asked for comment about the goals that a new separations regime should pursue, and in particular regarding the enunciated goals for and principles underlying comprehensive separations reform as described in the "Glide Path" papers.[1]

A. An "Exit Ramp"

The Glide Path papers demonstrate that since the current Separations Manual[2] was written, the network has undergone fundamental change. One has been the gradual deregulation of most incumbent LECs. Many states have now passed laws that permanently remove carriers from classical rate of return regulation by state commissions. As the 2005 Glide Path paper recognizes, this argues for the availability of a new and less burdensome separations regime for carriers in those states. If separations results are not relevant for any regulatory purpose, no carrier should bear the cost of conducting separations studies and reporting separations data. Accordingly, the FCC should establish an "exit ramp" option for incumbent carriers to terminate their separations obligations.

The appropriate conditions for carriers to actually exercise this "exit ramp" option may be surprisingly rigorous. Separations has become an element of many regulatory structures. Even where carriers have been "deregulated" or placed on price caps, separations data may still be needed, either by the company or by a regulator. In addition, some universal service programs depend upon separations data. For example:

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[1] FNPRM ¶ 30.

[2] The Separations Manual is codified in 37 C.F.R. Part 36.

- In the interstate jurisdiction most large carriers are on "price cap" regulation. For these carriers, switched access rates are set by rule at a uniform 0.55 cents per minute,[3] a rate that does not depend on annual cost separations calculations.[4] Nevertheless, separations rules can still affect these rates. Rates can be adjusted for "exogenous" factors if a carrier has low interstate earnings.[5] Separated costs are the starting point for calculating whether that precondition has been met.
- Also within the interstate jurisdiction, smaller carriers ("rate-of-return" carriers) use separation results directly to calculate their interstate access rates. Some carriers calculate these rates on a company-by-company basis. Most smaller carriers, however, participate in the NECA pools and charge uniform industry-wide rates. The NECA rates, while aggregated across many companies, still depend upon separations results. In sum, for both pooled and unpooled "rate-of-return" carriers, separations controls the amount of interstate costs, which then controls both per-minute "switched access" rates and "special access" rates.[6]
- In the state jurisdiction, a carrier may be on a so-called "price cap" or "alternative regulation" plan, but the state commission may

[3] *See* 47 C.F.R. § 61.3 (qq) (defining "Target Rate").

[4] *See* 47 C.F.R. § 69.152(d)(1). Subscriber Line Charges are also set by a formula that is not dependent on current separations results.

[5] *See* 47 C.F.R. § 61.45(b), (d)(1)(vii). Also, rates can be changed for "exogenous" factors if there are changes to separations rules. *See* 47 C.F.R. § 61.45(b), (d)(1)(iii). Exogenous changes, including separations changes, can also produce modifications to SLCs for any carrier not already charging the maximum SLC. *See* 47 C.F.R. § 69.104(n)–(p).

[6] NECA operates two different pools, a common line pool and a traffic sensitive pool. Each has separately identified costs, and each produces separate rates. The allocation of a carrier's overall costs into the two pools also relies on separations categories defined in Part 36.

nevertheless have a desire to evaluate intrastate earnings. For example, Verizon-Vermont was allowed in 2005 to continue on an "incentive regulation" plan, but only after the Vermont Public Service Board compared the financial results of this plan with classical rate-of-return regulation.[7]

- Also within the state jurisdiction, a carrier on a "price cap" or "alternative regulation" plan may challenge that plan on the ground that the plan is confiscatory in violation of the Fifth Amendment to the United States Constitution.[8]
- The High Cost Loop program is intended to limit the intrastate cost of providing high-cost areas served by smaller "rural telephone companies." High Cost Loop Support depends on "study area average unseparated loop cost per working loop." This in turn depends upon separations rules used to categorize outside plant and central office facilities.[9]
- The "Local Switching Support" program depends upon each company's "projected annual unseparated local switching revenue requirement."[10] This in turn, depends upon the separations rules used to categorize plant within central office plant accounts.

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[7] *Investigation into a Successor Incentive Regulation Plan for Verizon New England Inc., d/b/a Verizon Vermont,* Docket No. 6959, Order of 9/26/05 at 21-22 (Vermont Public Service Board, available at http://www.state.vt.us/psb/orders/2005/sep.htm#6959).

[8] Verizon-Vermont recently asserted this ground in a petition for reconsideration in Docket No. 6959 to the Vermont Public Service Board.

[9] *See* 47 C.F.R. § 36.631(c), (d). For example, support is provided for category 4.13 Circuit Equipment, which is a category of Central Office Equipment.

[10] *See* 47 C.F.R. §§ 54.301(a)(1).

- The "Interstate Common Line Support" program depends on each carrier's interstate "Common Line Revenue Requirement."[11] This in turn depends on the separations rules that categorize plant and expenses and the allocation rules that separate some of those costs to the interstate jurisdiction.

Any decision to eliminate a carrier's separations data should be made only after carefully examining all current uses of separations data. To avoid subsequent problems, a carrier should be allowed to take the "exit ramp" from separations only if several conditions are satisfied:

1. In the interstate jurisdiction, the carrier has waived the right to claim exogenous low-end rate adjustments.
2. In the state jurisdiction, the carrier has asserted that it is deregulated and has waived the right to subsequently claim an unconstitutional confiscation of its property.
3. The state commission has certified that it has no current use for separations results for that carrier and does not expect to have such a need.
4. The FCC has determined how USAC will calculate universal service payments after opt-out for that carrier and for other competing carriers serving the same area.
5. The FCC has determined that universal service programs can operate satisfactorily without any separations data inputs from that carrier.

[11] *See* 47 C.F.R. § 54.901(a).

B. Other Goals

The previous section discussed how carriers might exit from separations requirements. All of the following discussion applies to the remaining companies that will continue to be subject to separations, in some form.[12] This section discusses some goals for separations reform for such carriers.

1. Matching Revenue and Cost

The 2005 Glide Path Paper observed that "[s]o long as there remain two jurisdictions, cost assignment should at least roughly follow jurisdictional authority and revenue assignment." Matching revenues with costs is a paramount principle. To the extent that separations cannot consistently achieve this, several undesirable consequences will follow.

First, the jurisdiction receiving the revenues will have an incentive to reduce rates. The optimum rate for a competitive service is its incremental cost. Most network services already have a low total incremental cost, but mismatched separations rules can further reduce the costs that are apparent to a single jurisdiction. For the carrier, the temptation to reduce rates below cost will be strongest when the service is competitive. For the regulator, the temptation to reduce rates below cost will be strongest when the service is desirable and requires new capital expenditures over which the regulator has no direct control.

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[12] Nine independent telephone companies in Vermont are currently subject to a rate system established by statute. However, the Public Service Board can reestablish administrative regulation if it makes specified statutory findings. Moreover, this statutory system will sunset in 2008.

In the extreme, if the allocation rules set the cost at zero in one jurisdiction, the carrier and the regulator could both have an incentive to set rates at zero.

Second, the jurisdiction receiving the costs may be required to raise rates on other services. This would certainly violate the principle of cost causality. It would also be likely to harm consumers who purchase inelastic services and consumers who live and work in rural areas with minimal or no competition.

A cost-revenue mismatch would be likely to violate section 254(k) in two ways. To the extent that the service is competitive, it would likely fail to support its own costs and require contribution from less competitive services. It would thereby violate the first sentence of 254(k).

In addition, the second sentence of section 254(k) would be violated if the service produces revenue for the interstate jurisdiction, but sends costs to the state jurisdiction. To the extent that the state jurisdiction covers those costs by raising rates on local exchange,[13] a protected service. The resulting cost recovery might impose more than a reasonable share of joint and common costs on the local exchange service.

2. Match Jurisdiction With Both Revenue and Cost

The Glide Path paper also explained that it is important to match the regulatory jurisdiction over the price of a service with the cost of providing it. A

[13] Several components of local exchange service are "service[s] included in the definition of universal service." *See* 47 U.S.C. § 254(k); *see also* 47 C.F.R. § 254(c) (definition of universal service).

mismatch of this type does not produce the immediate economic harm generated by a cost-revenue mismatch. A different form of harm is likely in this case.

A regulator will have unpredictable incentives if he or she can set rates for a service but has no responsibility to allow recovery of the associated costs. The path of least resistance would be to deregulate the price, and leave the consequences to the other regulator. Such arrangements will not be stable in the long run, and it will be highly unlikely for prices to reflect actual costs, because those costs have been moved to the other jurisdiction.

Moreover, a mismatch between costs and jurisdiction may also produce section 254(k) problems. In a competitive environment an unregulated carrier has an incentive to subsidize its competitive services with revenues from its noncompetitive services. Also, many ILECs have some customers who have no competitive alternatives. An ILEC would have an incentive to collect more than a reasonable contribution to common costs from these customers.

3. Simplify and Reduce Overhead

The Glide Path II paper observed that it may be desirable to reduce dependence on costly measurement techniques.[14] This is an important goal of separations reform. The burden of Separations falls uniquely on incumbent LECs. While these incumbents also benefit in unique ways from the regulatory system, reducing their overhead cost is nevertheless a rational objective.

[14] 2005 Glide Path at 5.

Cost reduction can be accomplished most directly by simplifying the existing procedures. The FCC and the Joint Board should substantially reduce the complexity of the existing system, which requires a level of precision in some areas that greatly surpasses the precision of others that have far greater financial significance.

Much of the overhead cost of separations arises from usage studies. One possible simplification would be to move all usage-based factors to a single fixed factor for all companies.[15] This alone could reduce separations overhead costs substantially. Also, categorization of plant and expense accounts should be avoided, whenever possible.

Nevertheless, carriers differ in how much of their operations are devoted to services that produce interstate revenue only or intrastate revenue only. Because these inter-company differences are likely to persist, it may not be possible to avoid all categorization and all usage studies.

4. Exclude Costs Associated With Non-Regulated Services

The Commission has declared some services to be non-regulated non-telecommunications services. Notably, the Commission held in 2005 that wireline broadband Internet access service provided over a provider's own facilities is an information service, not a telecommunications service.[16]

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[15] A multi-year phase-in period might be used to reduce the rate impacts of shifting to fixed factors. When the 75-25 factor was adopted in the 1980's it was phased in over several years.

[16] Report and Order and Notice of Proposed Rulemaking, *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, CC Docket No. 02-33, (FCC 05-150, released Sept.

Nevertheless, the Commission did not require that the investment associated with these information services be excluded from the costs of regulated services.[17] It recognized that if it "preemptively deregulated" these services the associated investment and expense would, under existing Part 64 rules, necessarily be excluded from amounts subject to separations. To avoid this result the Commission created a new category.[18] Wireline broadband service is now an information service whose facilities are included in rate base. However, under Part 64 rules, states may remove those costs if they wish, even though they have been identified as regulated for federal purposes.[19] In sum, wireline broadband is "semi-deregulated."

Under this order, the FCC and the individual states may now take quite different approaches to wireline broadband facilities and expenses. They may reach quite different decisions about whether it is regulated, what portions of common facilities and expenses are attributable to the service and, not least, how state decisions to exclude nonregulated investment might affect the separations factors and categories developed under Part 36 for regulated plant and expense.

23, 2005), ¶ 12. The Commission also gave carriers a choice of whether to treat their broadband transmission services as Title II telecommunications services or information services. *Id.* ¶ 138.

[17] The FCC held that to require incumbent LECs to classify their non-common carrier, broadband Internet access transmission activities as nonregulated activities under part 64 rules would impose significant burdens that outweighed the potential benefits. *Id.* ¶ 134.

[18] *Id.* ¶ 130.

[19] *Id.* ¶ 129.

The Joint Board and the Commission should seek a uniform method to adapt the separations process to the increased importance of new services like wireline broadband. New rules are clearly needed. State laws that impose economic regulation on these services should not be preempted. However, to the extent that states elect to impose such regulation, the states should nevertheless act within the limits of a national framework that offers common definitions for costs and provides common rules for the jurisdictional separation of the costs and revenues from these services. Unless the Joint Board and Commission solve this problem, carriers face a risk of recovering more or less than 100 percent of their total investment. Decades ago, it was precisely this kind of risk that led to the creation of the existing Joint Board on Separations.

III. THE FREEZE

In 2001, the FCC froze separations factors based on factors used in calendar 2000. In addition, "categories" were frozen for price cap carriers, also based upon calendar 2000 categories. In May of this year, the FCC extended both freezes for an additional three years, or until comprehensive separations reform can be completed, whichever occurs first.[20]

A. The Factor Freeze and Jurisdictional Rulings

The factor freeze has frozen separations factors based upon usage. Although those usage factors would probably produce a different result based on

[20] This decision was reached in the same item to which these comments respond.

today's usage patterns, for two reasons the freeze has probably not caused any significant harm to consumers.

First, interstate toll traffic has declined during the freeze. Therefore, to the extent that usage has not been updated, costs have remained in the interstate jurisdiction, and the error has probably not harmed local exchange ratepayers.

Second, although companies are still using factors calculated in 2000, the majority of investment and expense is actually separated by the 75%-25% fixed factor, which has itself essentially been frozen since it was announced in 1984.[21] The end of the factor freeze would leave this most important factor unchanged, and therefore the overall separations factors for most companies would not be greatly affected by updating usage-based factors.

On the other hand, the FCC has made jurisdictional rulings during the freeze that are highly relevant to the factor freeze.

- As noted in the 2005 Glide Path paper, the FCC has found that switched traffic terminating at an ISP, and VoIP traffic terminating on the switched network are both interstate, even though they may appear to be intrastate local traffic.[22] As a result, the interstate jurisdiction newly extends to a substantial proportion of apparently local traffic. This jurisdictional change suggests that both the fixed 75-25 factor adopted in 1984, as well as usage-based factors derived

[21] *See Jurisdictional Separations Procedures, Amendment of the Commission's Rules and Establishment of a Joint Board*, CC Docket No. 80-286, 49 Fed. Reg. 7934 (Mar. 2, 1984). The 75-25 factor was phased in and was not fully implemented until 1993. *See* 47 C.F.R. § 36.154(c), (d)).

[22] 2005 Glide Path Paper at 6.

from 2000 traffic patterns, are inadequate to describe the jurisdictional usage of the modern network.

- Many carriers now offer retail DSL services through affiliates. The FCC has decided that, at the carrier's option, the wholesale transaction can now generate interstate revenue or nonregulated revenue.[23] DSL technology, however, relies heavily upon the existence of joint use copper loops, and existing separations rules still use the pre-DSL factor. 75% of the cost of loops is assigned to the state jurisdiction, even when DSL is the service that generates most (or in some cases all) of the revenues on that loop. At best, therefore, existing rules do not require DSL to make any contribution to joint loop costs. At worst: DSL may be the cause in fact of substantial incremental loop costs to upgrade existing plant, while the majority of those costs get assigned to intrastate; and switched service revenue can disappear if the carrier provides only DSL on the loop. Under these circumstances it is not reasonable to assign 75 percent of loop costs to the state jurisdiction.
- Even larger cost-revenue mismatches may be occurring with the newer fiber systems, particularly where fiber is being installed and directly connected to the end user. Those new systems require total replacement of the existing distribution network and the installation of new and very expensive Network Interface Devices for every customer. Under the existing separations rules, although incremental revenues from these networks are interstate or nonregulated, the great majority of the incremental costs are separated to intrastate.

[23] Report and Order and Notice of Proposed Rulemaking, *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, CC Docket No. 02-33, (FCC 05-150, released Sept. 23, 2005).

These jurisdictional rulings and technology changes require an end to the factor freeze in 2009. Thereafter, the FCC and Joint Board should seriously consider taking the following actions:

1. Adjust the 75-25 fixed factor applicable to all loops so as to increase the interstate share.
2. Adjust usage-based separations factors to adjust for ISP traffic and VoIP.
3. Adopt a new fixed factor for DSL and fiber loops or develop a new separation method for DSL services, fiber services and other services that generate only interstate or preemptively nonregulated revenues.

B. The Category Freeze and Special Access

The FNPRM asks for comment on the effects of separations reform on the evaluation of special access rates.[24]

During the freeze, categories have been frozen for price cap carriers. However, when the original freeze was adopted, both the Joint Board[25] and the Commission[26] recognized that the rapid increase in interstate special access sales required continuing scrutiny. Nevertheless, the Joint Board and the Commission have failed to take any meaningful action during the five years of the freeze. The existing problems were exacerbated by a post-freeze opinion from an FCC staffer,

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[24] FNPRM ¶ 36.

[25] Recommended Decision, *Matter of Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286 (FCC 00J-2, released July 21, 2000), ¶ 27 (referring to "private lines").

[26] Report and Order, *Matter of Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286 (FCC 01-162, released May 22, 2001), ¶¶ 31, 33 (referring to "private lines").

and they have now grown so serious that the category freeze cannot be further extended.

As originally envisioned in 2000 and 2001, carriers would continue to directly assign special access circuits every year.[27] If carriers had indeed done this, increasing sales of interstate special access lines would not be a problem today. Interstate revenues and costs would both be higher. While the match might not be precise, it would arguably be consistent with the level of precision historically achieved by separations.

However, in 2004, an FCC employee issued a letter that directly contradicted the FCC's rules as well as the intent of the Joint Board that recommended the freeze. The letter stated that carriers were not permitted to make any adjustment to any frozen categories until the freeze expires.[28] As a result, carriers are still categorizing their loop plant using the investment amounts, and the direct assignment ratios, that were calculated in 2000. For example, if ten percent of cable and wire investment was allocated to category 1.2 (interstate private lines) in 2000, only ten percent is reported today in that category. Therefore, this FCC staff letter is preventing carriers from directly assigning new interstate special access investment to the interstate jurisdiction.

[27] *See, e.g.* 36 C.F.R. § 36.154(g) ("Direct assignment of subcategory Categories 1.1 and 1.2 Exchange Line C&WF to the jurisdictions shall be updated annually as specified in § 36.154(b)").

[28] Letter from Fatina Franklin, Ass't Division Chief, Industry Analysis and Technology Division, Wireline Competition Bureau to Ann Berkowitz, Verizon Communications, June 9, 2004.

Because of the interlinked nature of the separations rules, this has a significant effect on the separation of expenses as well.

As shown in Figure 1, special access circuits have grown enormously since 2000. In 2000, large ARMIS ILECs reported 43 special lines for every 100 switched lines. By 2005, the two services had switched places, and the same carriers reported 151 special access lines for every 100 switched lines.

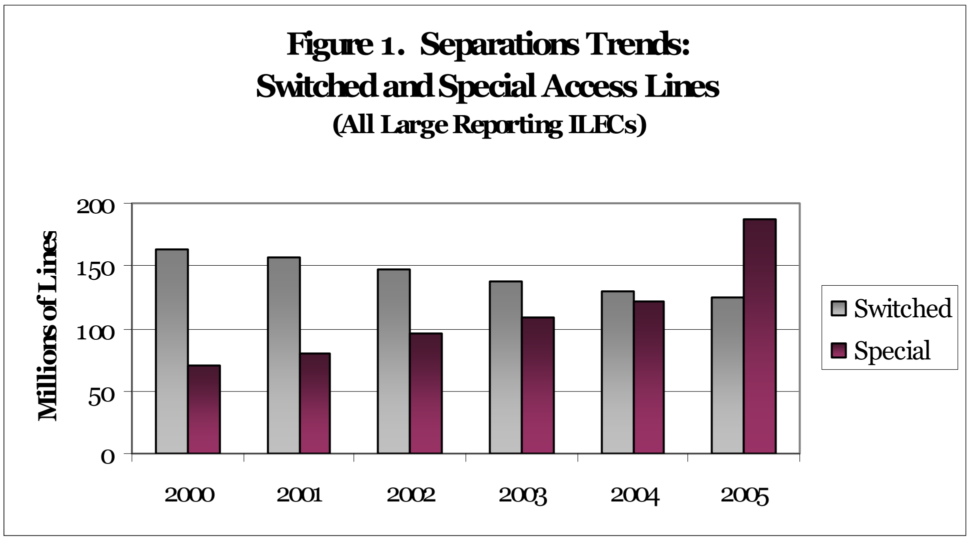

Figure 1. Separations Trends: Switched and Special Access Lines (All Large Reporting ILECs)

This expansion of interstate special access lines has produced a parallel increase in interstate special access revenues. According to ARMIS, in 2000 all large companies received 9.5 percent of their total operating revenues (subject to separations) in the form of special access revenue. By 2005, that had increased to 17.4 percent. The revenue share nearly doubled in five years.

By contrast, the category freeze (and the FCC staff letter) blocked any parallel shift in costs. In 2000 the large ARMIS companies separated 7.3 percent of their total operating expense (subject to separations) to special access expense. By 2005, that figure had increased only slightly, to 8.5 percent.

Profits increase when revenues increase faster than costs. ARMIS confirms this effect for large ILECs. By 2005 the interstate special access operations of large ILECs earned an average net return on investment of 91 percent. Several companies earned more than 200 percent, and the highest single case was 309 percent.[29]

Underestimating special access costs may also overstate switched service costs. Depending on the circumstances, this could also increase interstate subscriber line charges and interstate switched access rates.[30]

Neither high interstate return for special access, high SLCs or interstate access rates are matters within the direct jurisdiction of state regulators. However, there are also consequences for state rates. States have a legitimate cause for concern if a high return on interstate special access arises from a revenue mismatch. A separations error that erroneously raises interstate earnings will also erroneously lower intrastate earnings, and this can provide a basis for a request to increase intrastate rates. Moreover, an error of this type could produce an implicit subsidy of interstate special access services by intrastate

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[29] This number is reported directly by ARMIS Report 43-01 for Puerto Rico Central Telephone Company. Other cases were calculated from ARMIS revenue, expense and tax data.

[30] When costs are not directly assigned to special access, they are assigned to switched services. This can increase Subscriber Line Charges in areas where those charges are not capped. It can also increase interstate switched transport costs for rural LECs and increase their costs reported to NECA.

subscriber charges or switched access rates. This could also lead to violation of either sentence of section 254(k) because special access services are both more competitive than switched access, and not part of the services supported by universal service.

In sum, separations outputs for special access are seriously out of balance, and the problem is now large enough to have a significant impact on total costs. Barring unforeseen events, the Commission should abandon the category freeze in 2009 when the current freeze expires. The FCC and the Joint Board should consider taking one of the following actions:

1. Requiring a single re-categorization study in 2009 when the freeze expires, at least for special access lines; or
2. Developing a new separation method for special access and other services that generate only interstate or preemptively nonregulated revenues.

IV. New Separations Manual

For several reasons, the Commission should undertake now to rewrite the Part 36 separations manual. First, the industry seems unable to comply with the existing separations manual. The comments by USTA and other carriers earlier this year show that compliance with Part 36 is extremely costly. The LEC industry will be highly likely to resist any effort to mandate compliance with existing rules when the freeze expires in 2009.

As noted above, carriers need to be offered an exit ramp from separations. This in itself requires a rule change. For carriers that remain subject to separations, it is probably not possible to devise a cost-free system, but the existing Part 36 rules are clearly obsolete, and they may do more harm than good in their present state.

The most fundamental problem for a new separations manual is to develop sensible rules for digital and Internet services. The preceding sections commented that it would be useful to develop new rules for special access, wireline broadband, DSL and fiber service. While the regulatory details vary, in each case the problem is similar.

- States neither set rates nor receive revenues. The Commission has exercised varying degrees of authority over the services, but in each case the states are constrained (except as to the relatively minor category of intrastate special access) from regulating the rates for these services, and ILECs record the revenues as interstate.
- The services use facilities common to the switched network. In most or all cases, some facilities are used in common. Most frequently this is the loop, but some services also use central office equipment.
- The services make little or no contribution to common costs. With DSL, for example, specialized equipment ("DSLAMs") may be directly assigned to interstate, but the fact that DSL is sold over a switched loop does not reduce the costs assigned to that loop, and no part of the DSL revenues are used to cover switched service costs.
- When the services generate incremental costs, the majority of those costs are assigned to the state jurisdiction. These new digital services generally require some incremental investment to existing

common plant.[31] The existing separations rules[32] then separate the majority of those incremental costs to the state.

The FCC and the Joint Board should develop a new method to categorize plant and expenses. It should be simpler than the existing rules, but it should also adapt well to local circumstances, to changing patterns of carrier investment and to new jurisdictional rulings. Where the commission has eliminated the ability of the states to set rates for a service, or where the revenue from a service is allocated to interstate, the system should remove the investment, expense and revenue for that service from the state jurisdiction, either universally by FCC rule or on a case-by-case basis following a state election. One possible method to remove these costs would be to categorize by measuring the ILEC's peak network capacity. This technique should more closely approximate cost causation over time, particularly as networks evolve to digital services.

The new system may appropriately rely more on fixed factors than on usage-based factors, but it will need other elements as well. Carriers vary greatly in how broadly they have deployed the new digital services, and basic fairness will require collecting at least some forms of company-specific data. It may also still be useful to continue to measure interstate toll calling rates because usage in

[31] Again using DSL as an example, providing DSL may require loop upgrades that create incremental investment and incremental expense. Those costs generally are not directly assigned, but are picked up through normal switched service recovery mechanisms.

[32] The fixed 75-25 separations factor for loop plant probably assigns most of such costs, but the frozen usage-based factors may also contribute, and often assign even a higher percentage of costs to the state.

some parts of the country, usually border areas, continue to rely heavily upon interstate switched calling.

It may also be useful to examine the potential of "expense transfers." The Commission first established the High Cost Loop program in 1984 to reduce the impacts of other separations changes on local exchange rates. However, rather than requiring that the universal service revenue be assigned directly to the state jurisdiction, it instead established an "expense transfer." Under this rule, a company transfers expenses from the state to the interstate jurisdiction in an amount equal to its USF revenue. The effect is still to reduce local rates, because the expense transfer lowers intrastate costs. A new expense transfer mechanism may be useful in defining the contribution that digital services should make to the costs of jointly used plant.[33]

A rewrite of Part 36 should also address problems with the current treatment of unbundled network elements ("UNEs"). It appears that some carriers are thereby creating cost-revenue mismatches for UNEs. Solving this problem may be less difficult than the digital service problem, but it will still require either a rule change or, at minimum, an accounting clarification letter from the FCC.

With the extended freeze set to expire in 2009, this is a perfect time for the Commission, and the Joint Board, to undertake a long-range project to update

[33] For example, the FCC might mandate an expense transfer equal to 50% of DSL revenue.

separations for the digital communications age. A new system should impose fewer costs on carriers, yet still achieve the legal goals set out in 1930 by the Supreme Court in *Smith v. Illinois Telephone* and by more modern statutory creations such as 47 U.S.C. § 254(k).

Respectfully submitted this 22nd day of August, 2006.

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